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CDS and the crisis

Many factors have been identified as contributing to the financial crisis. If we were to produce a Top 10 list of these, it would surely include credit derivatives (although we might not agree with this). Credit default swaps (CDSs) are the most significant component of the credit derivatives market, which has grown in recent years. But no one is quite sure how large it actually is.

Before the growth of credit derivatives, credit was an area of risk for which there was no tailored risk management product, with loan assignments and participations being the dominant vehicles. As a result, credit risk management was limited and the credit markets were dominated by depositary institutions. Credit derivatives isolate specific aspects of risk relating to referenced bonds and/or entities and transfer that risk. Many compare a CDS to an insurance contract. However, under an insurance contract, payment is conditioned on the beneficiary suffering an actual loss, which is not the case with CDS.

The CDS market has been referred to as a black hole. In 2007, when insurer AIG first disclosed it held more than $440 billion of credit swap trades linked to CDS, market participants realised that a lack of transparency had obscured the actual size of CDS exposures. Others noted that the availability of CDSs may have encouraged banks and insurers to take on more risk than they could actually handle. The CDS market has been tested in recent months by the occurrence of credit events relating (but not limited) to Bear Stearns, the GSEs and Lehman. During this period, CDS auctions have functioned. Nonetheless, federal and state regulators have called for CDS market oversight. It is not clear which regulator has or would have authority for this. It is also not clear whether CDSs would be deemed insurance contracts. In recent weeks, the Securities and Exchange Commission has granted approvals and exemptions enabling the creation of an exchange (and effectively a single counterparty) to trade and clear CDS. Several rival exchange operators have yet to be approved.

Certainly, the hue and cry over the alleged ill effects of credit derivatives precluded any opportunity to note their benefits (pricing and risk transfer) or that, despite the magnitude and severity of recent credit events, industry supported auction mechanisms have facilitated orderly settlements and unwinds among market participants. Such observations may have to wait for less turbulent times.